No. 16285.

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

Citizens National Trust and Savings Bank of Los Angeles,

Appellant,

vs.

United States of America,

Appellee.

APPELLEE'S BRIEF.

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Citizens National Trust and Savings Bank of Los Angeles,

Appellant,

vs.

United States of America,

Appellee.

APPELLEE'S BRIEF.

I.
JURISDICTION.

Appellee, the United States of America, commenced its action against Appellant in the United States District Court for the Southern District of California, Central Division, designated Civil Action No. 54-58-HW, on January 20, 1958.

Appellee's action involved a transaction under the National Housing Act, as amended, and was brought in the said United States District Court pursuant to the provisions of Title 28 U. S. C., Section 1345. Appellant Bank, as the defendant in said action, was and now is a national banking association, organized and existing under and by virtue of the laws of the United States of America, and

at all relevant times had a place of business in the City of Los Angeles, County of Los Angeles, and State of California, and thus was and is within the jurisdiction of the said United States District Court. Therefore, by virtue of the foregoing, said Court had jurisdiction over the subject matter of said action and the parties thereto.

The United States Court of Appeals for the Ninth Circuit has jurisdiction to review the judgment given in said action, pursuant to Title 28 U. S. C., Section 1291.

II.
STATUTES AND REGULATIONS INVOLVED.

Statute.

The National Housing Act, as amended, 12 U. S. C., Section 1703:

> "(a) The Commissioner is authorized and empowered upon such terms and conditions as he may prescribe, to insure banks . . . and other such financial institutions, which the Commissioner finds to be qualified by experience or facilities and approves as eligible for credit insurance, against losses which they may sustain as a result of loans and advances of credit . . . made by them on and after July 1, 1939 and prior to July 1, 1955, for the purpose of financing alterations, repairs, and improvements upon or in connection with existing structures . . . by the owners thereof. . . .
>
> "(g) The Commissioner is authorized and directed to make such rules and regulations as may be necessary to carry out the provisions of this subchapter."

Regulations.

24 C. F. R. 201.2 Definitions

(a) "Act" means the National Housing Act, as amended.

(b) "Administration" means the Federal Housing Administration.

(c) "Commissioner" means the Federal Housing Commissioner or his duly authorized representative.

(d) "Contract of Insurance" includes all of the provisions of the regulations in this part and of the applicable provisions of the Act.

* * * * * * * *

(i) "Borrower" means one who applies for and receives a loan in reliance upon the provisions of the Act and whose interest in the property to be improved is (1) a fee title, or (2) a life estate, or (3) an equitable interest under an instrument of trust or contract, or (4) a lease having a fixed term, expiring not less than six calendar months after maturity of the loan.

(j) "Class 1(a) Loan" means a loan . . . which is for the purpose of financing the repair, alteration, or improvement of an existing structure or of the real property in connection therewith, exclusive of the building of new structures. The term "existing structure" is a completed building that has or had a distinctive functional use."

24 C. F. R. 201.3 "Eligible Notes—(a) Validity

The note shall bear the genuine signature of the borrower as maker, shall be valid and enforceable against the borrower or borrowers as defined in Section 201.2(i), and shall be complete and regular on its face. . . ."

24 C. F. R. 201.11 "Claims—(a) Claim application

Claim for reimbursement for loss on an eligible loan shall be made on a form provided by the Commissioner, and executed by a duly qualified officer of the insured. The claim shall be accompanied by the insured's complete credit and collection file pertaining to the transaction."

(g) *Form of assignment.*

The following form of assignment properly dated shall be used in assigning a note, judgment, real estate mortgage, deed of trust, conditional sales contract, chattel mortgage, mechanic's lien, or any other security device in event of claim:

> 'All right, title, and interest of the undersigned is hereby assigned (without warranty, except that the note qualifies for insurance) to the United States of America.
>
> ....
> (Financial Institution)
>
> By ....
>
> 'Date .... Title ....'"

24 C. F. R. 201.16 "Effective date

The regulations in this part are effective as to all loans made on or after July 1, 1947, pursuant to the provisions of Title 1 of the National Housing Act as amended, and shall have the same force and effect as if included in and made a part of each Contract of Insurance."

III.

STATEMENT OF THE CASE.

This case was submitted to the trial court for decision primarily upon a written Stipulation of Facts [R. 14-16]. Said Stipulation is as follows:

> "1. That as alleged in plaintiff's complaint, on or about April 17, 1952, one George D. Bashore executed and delivered to Durastone Co., as principal, his promissory note in writing dated on said date wherein the said Bashore promised to pay, for value received, to the order of said principal, the sum of $1,638.46. The execution and delivery of said note was under the terms of Title I of the National Housing Act. That under the terms of said Act the Federal Housing Administrator acting for and on behalf of plaintiff insured the payment of said note at the special instance and request of defendant bank.
>
> "2. That thereafter the payee of the note, to wit, Durastone Co., as principal, transferred the same by endorsement to defendant bank. Thereafter the maker, Bashore, after making some eighteen monthly payments on the note defaulted and failed to pay any further payments thereon. Thereafter, by reason of said default, defendant bank acting under the terms of the aforementioned National Housing Act made demand for reimbursement of the amount remaining due on the note, to wit, the sum of $793.84, and the same was paid by the Federal Housing Administrator and the note was transferred by defendant bank to the plaintiff. The transfer of said note to plaintiff by defendant bank was evidenced by the latter's endorsement on the reverse side thereof containing the words: 'All right, title and interest of the undersigned is hereby assigned (without warranty, except that the note qualifies for insurance) to the United States of

America.' That the defendant bank in making demand for reimbursement of the balance remaining unpaid on said note to the Federal Housing Administration certified that the terms of the contract and of the regulations have been complied with.

"3. That following the transfer of the note to plaintiff, as aforementioned, plaintiff on or about February 21, 1956, filed an action against the maker, Bashore, to collect the balance due and unpaid on said note, and being the action referred to in plaintiff's complaint, to wit, No. 19527-WM Civil, in the United States District Court, Southern District of California, Central Division. Judgment in said action was that the plaintiff, United States of America, take nothing from the defendant Bashore on its complaint. A copy of said judgment of the court in said action is attached hereto, marked Exhibit 'A,' *and by reference made a part hereof.* (Emphasis supplied.)

"4. Defendant bank herein was not made a party to the said action and is not a party to the judgment made and given therein as aforesaid.

"5. That as alleged in plaintiff's complaint, at all times mentioned therein defendant bank was the insured party to a contract of insurance, the insuring party being the Federal Housing Commissioner, acting for and on behalf of the United States of America, said contract of insurance being entered into under and governed by the provisions of Title I of the National Housing Act, as amended (12 USC, Sec. 1703). That the said contract of insurance by its provisions require the insured party to abide by its terms and by the regulations of the Administrator enacted in pursuance thereto."

The judgment of the trial court in the said case of *United States v. Bashore,* Civil No. 19527-WM [R. 17-

22], as referred to in Paragraph 3 of the foregoing Stipulation, appears as Exhibit "A" in the Transcript of Record, pages 17-22.

Although not agreed upon in the above Stipulation, the Appellee further averred in his "Memorandum of Points and Authorities" that, although the Appellant bank was not made a party to the aforesaid case of *United States v. Bashore,* Civil. No. 19527-WM, it was, in fact, informed of said action, and, indeed, had its counsel in attendance at and during the trial of said action. Said averment was not denied in the Appellant's "Reply to Plaintiff's Memorandum of Points and Authorities," or thereafter; and the trial court found that "though defendant Citizens National Trust and Savings Bank of Los Angeles was not made a party to the said action No. 19527-WM Civil, in the United States District Court, Southern District of California, defendant (Appellant) and its counsel were in fact informed of said action previous to trial" [R. 33].

In the Findings of Fact made by Judge Mathes in the aforesaid case of *United States v. Bashore* it was found, in effect, that the payee of the note, one Durastone Company, had misrepresented basic facts to the said defendant therein, as a result of which the latter was induced to execute and sign the Promissory Note and other documents connected therewith, "the true effect of which was misrepresented to him"; that said defendant "did not know or ascertain until long after the event that he had signed the instrument in suit or any other document negotiable in form"; that the consideration promised to said defendant by the Durastone Co. had not been received by him and is "totally lacking"; that since the Appellant herein had supplied the said payee with its own printed forms of Promissory Note and Federal Housing Administration Title I

Credit Application for use in the transaction involved, it was "charged with knowledge and the transaction was subject to the Regulations promulgated by the Federal Housing Administrator"; that since the Appellant was charged with notice of said regulations it took the Promissory Note with knowledge of the defects therein and therefore was not a holder in due course; that the Appellant was in such a relationship to the payee, the aforesaid Durastone Company, that it must be considered in effect a party to the original transaction between the payee and the defendant Bashore; and that the plaintiff (Appellee herein) became a holder of the Promissory Note after maturity and with notice of the defect therein and thus did not derive its title through a holder in due course [R. 17-21].

The conclusions of law reached by the trial court in the said case of *United States v. Bashore* were essentially as follows: That the defendant Bashore had not been negligent with respect to his part in the transaction; that the Citizens National Trust and Savings Bank (Appellant herein) did not become a holder in due course of the note in question; that the plaintiff (Appellee herein) is not a holder in due course of said note but held it subject to the defenses of failure of consideration, fraud, and misrepresentation; that the Citizens National Trust and Savings Bank (Appellant herein) discounted said note with knowledge that it was void and unenforceable; and that, consequently, the said defendant was not indebted to the plaintiff (Appellee herein) with respect to the transactions secured by said note [R. 17-22].

After submission of the instant case to the trial court herein for decision on the basis of said Stipulation of Facts, plus the undenied averment of the Appellee that the Appellant had been aware of the previous action of

United States v. Bashore and had, in fact, attended the trial thereof, the trial court, on October 8, 1958, filed its Findings of Fact and Conclusions of Law and rendered Judgment that the Appellee recover the sum of $793.84 from the Appellant, together with interest at the rate of 6 per cent from June 23, 1955, and its costs [R. 29-35].

The primary Findings of Fact made by the trial court were that the transfer of said note to the Appellee by the Appellant Bank was evidenced by the latter's endorsement on the reverse side thereof containing the words: "All right, title and interest of the undersigned is hereby assigned (without warranty, except that the note qualifies for insurance) to the United States of America"; that the Appellant in making demand for reimbursement certified that the terms of the insurance contract and of the regulations had been complied with; that after said assignment of the note to the Appellee, the latter commenced an action against the payee, the aforesaid Bashore, but took nothing in said action because of findings to the effect that the payee had obtained the note by fraud; that the payee's endorsee, the Appellant herein, was not a holder in due course; that the note was void and unenforceable as to said defendant Bashore; that the time for an appeal from the aforesaid judgment has expired and that, therefore, it is final; that the Appellant herein "was not made a party to said action and is not a party to the judgment made and given therein"; that the contract of insurance requires that the insured party abide by the terms and regulations of the Administrator and that said regulations require that a note be "valid and enforceable against the borrower" in order to qualify for insurance; and that though the Appellant was not a party to said action of *United States v. Bashore,* it was "in fact informed of said action previous to trial" [R. 30-33].

The Conclusions of Law reached by the trial court herein were essentially that "a judge of this court heretofore having held that the note was not valid and enforceable against the borrower, this court cannot go behind such a finding"; that the Appellant warranted that the note qualified for insurance, "that is, was valid and enforceable against the borrower, not that the note could be collected"; that the Appellant, having expressly warranted the note to be valid and enforceable, is bound by this warranty regardless of its knowledge concerning any defects therein; that said warranty was breached and that, therefore, the Appellant is liable to the Appellee under said warranty [R. 34-35].

Thereafter, the Appellant moved the trial court for a new trial [R. 36-37] but on November 3, 1958, the court denied said Motion [R. 37-38].

Thereupon, the Appellant, on November 25, 1958, filed its Notice of Appeal from the aforesaid Judgment.

IV.
SUMMARY OF ARGUMENT.

A.

THE APPELLANT'S "SPECIFICATION OF ERRORS," IN PART, IMPROPERLY SEEKS TO IMPEACH AND REPUDIATE ITS OWN STIPULATION OF FACTS IN THE TRIAL COURT.

B.

THE TRIAL COURT DID NOT ERR IN RULING THAT "A JUDGE OF THIS COURT HERETOFORE HAVING HELD THAT THE NOTE WAS NOT VALID AND ENFORCEABLE AGAINST THE BORROWER, THIS COURT CANNOT GO BEHIND SUCH A FINDING."

C.

THE TRIAL COURT DID NOT ERR, AS APPELLANT CONTENDS, "IN CONCLUDING IN EFFECT THAT IN EVERY CASE WHERE A PROMISSORY NOTE IS MADE AND GIVEN UNDER THE TERMS OF TITLE I OF THE NATIONAL HOUSING ACT, AND IS LATER FOUND TO BE INVALID AND UNENFORCEABLE AGAINST THE BORROWER, THAT THIS IS NECESSARILY CONCLUSIVE THAT THE NOTE WOULD BE INELIGIBLE FOR THE INSURANCE COVERAGE UNDER SAID ACT" SINCE IT REACHED NO SUCH CONCLUSION AND SINCE SUCH A CONCLUSION WOULD BE SUPERFLUOUS IN ANY EVENT.

D.

THE TRIAL COURT DID NOT ERR, AS APPELLANT CONTENDS, BY "CASTING THE ROLE OF THE APPELLEE AS BEING THAT OF AN ASSIGNEE OF AN ORDINARY PROMISSORY NOTE, RATHER THAN THAT OF AN INSURER TO A LENDING INSTITUTION AGAINST LOSS OCCASIONED BY A LOAN MADE UNDER THE TERMS OF THE NATIONAL HOUSING ACT," BECAUSE THE TRIAL COURT APPLIED NO SUCH THEORY AND BECAUSE IN ANY EVENT, IT IS NOT THE THEORY APPLIED BUT THE CONCLUSION REACHED WHICH IS DETERMINATIVE.

E.

THE TRIAL COURT COULD PROPERLY REFUSE TO LITIGATE THE ISSUES ACTUALLY DECIDED IN UNITED STATES v. BASHORE BECAUSE OF PRIVITY OR A SIMILAR RELATIONSHIP BETWEEN APPELLANT AND APPELLEE.

F.

THE TRIAL COURT WAS CLEARLY CORRECT IN DECIDING THAT THE "NOTE" IN QUESTION, HAVING BEEN FOUND INVALID AND UNENFORCEABLE AGAINST THE BORROWER, DID NOT QUALIFY FOR INSURANCE AND, THEREFORE, THAT THE APPELLANT BREACHED ITS WARRANTY TO THE APPELLEE.

G.

THE APPELLEE IS NOT BARRED FROM RECOVERY BECAUSE IT VOLUNTARILY INDEMNIFIED THE APPELLANT UNDER A MISTAKE OF LAW.

V.

ARGUMENT.

A.

The Appellant's "Specifications of Errors," in Part, Improperly Seeks to Impeach and Repudiate Its Own Stipulation of Facts in the Trial Court.

Paragraph (1) of Appellant's "Specifications of Errors" erroneously avers that:

> "The only evidence before the court, and relied upon by the Appellee on the issue of insurability, was the fact that Appellee's action brought against the borrower, and in which action Appellee was not a party, and which insurability of the note was not in issue, the court had awarded judgment in favor of the borrower" (Appellant's Br. p. 5).

Such contention completely ignores the fact that in the trial court the Appellant joined the Appellee in a "Stipulation of Facts," which under paragraph 3 thereof stated, *inter alia:*

> "A copy of said judgment of the court in said action (U. S. v. Bashore, No. 19527-WM Civil) is attached hereto, marked Exhibit 'A' and *by reference made a part hereof.*" [Emphasis supplied; R. 14-16.]

By said Stipulation the parties to this appeal adopted, in effect, all of the 'basic" facts found by the trial court in said previous action between the Appellee and the borrower. The case was submitted to the trial court for decision on the basis of said Stipulation. Implicit in all of the trial briefs and the memoranda filed by both Appellant and Appellee is an acceptance of certain findings of fact made by the trial court in *United States v. Bashore,* notably those embodied in paragraphs II through VIII

thereof, along with that portion of paragraph XI which states:

> "That the plaintiff (Appellee herein) became a holder of the Promissory Note dated April 17, 1952, after maturity and with notice of the defect therein. . . ."

Also impliedly accepted by said Stipulation in conjunction with the trial briefs and memoranda was paragraph III of the Conclusions of Law in *United States v. Bashore,* to wit: "That defendant, George D. Bashore, by his conduct and lack of knowledge may not under the evidence presented be held negligent" [R. 21]. The appellant offered no evidence that Bashore, in fact, had been negligent, and has made no such contention in his written or oral arguments herein.

The trial briefs and memoranda indicate that the remaining relevant portions of the Findings of Fact in *United States v. Bashore* which, perhaps, can more accurately be described as ultimate facts or mixed findings of fact and law—were not agreed upon but presumably were at issue. These portions are as follows:

> "IX. That . . . the same Bank took the Promissory Note dated April 17, 1952, with knowledge of the defect therein and did not therefore become a holder in due course.
>
> "X. That the relationship between the payee of the Promissory Note dated April 17, 1952, . . . to wit, Durastone Co., and the Citizens National Trust and Savings Bank of Los Angeles, . . . was such that said Bank must be considered in effect a party to the original transaction between the named payee and the defendant, George D. Bashore.
>
> "XI. . . . that the Court further finds that plaintiff (Appellee herein) did not derive his title to

> said Promissory Note through a holder in due course." [R. 20-21.]

It is significant that although it disputed the foregoing Findings, the Appellant introduced no evidence to show that they are erroneous. Consequently, his position at the trial and on this appeal was and is essentially that said conclusions are erroneously drawn from the stipulated facts.

Consequently, it is wholly unsound to argue, as has Appellant under said Paragraph (1) of its "Specifications of Errors," that

> "the only evidence before the court and relied upon by the Appellee on the issue of insurability, was the fact that in Appellee's action brought against the borrower, and in which action the Appellant was not a party, and in which insurability of the note was not an issue, the court had awarded judgment in favor of the borrower." (Appellant's Br. p. 5.)

The trial court herein had before it a solid core of stipulated facts relative to the transaction and parties involved and to that core it added other findings of fact, and from all of the facts so found it reached its conclusions of law and final judgment.

The Appellant cannot have two shots at the same target. Having voluntarily elected to accept the said findings of fact in *United States v. Bashore,* it cannot repudiate them now.

Consequently, this review, *inter alia,* must be predicated upon the following findings of fact in *United States v. Bashore, supra:*

> "III.
>
> "That on or about April 17, 1952, defendant George D. Bashore was approached by agents of the Dura-

stone Co. and that said agents misrepresented basic facts to said defendant in that said defendant was informed and believed that certain mastic paint would be applied to the defendant's home free of charge; that said defendant did execute and sign the Promissory Note and other documents in question, *the true effect of which was misrepresented to him.*" (Emphasis supplied.)

"IV.

"That defendant, George D. Bashore, did not know or ascertain *until long after the event that he had signed the instrument in suit or any other document negotiable in form.*" (Emphasis supplied.)

"V.

"That the consideration promised to defendant by the Durastone Company has not been received by said defendant and is totally lacking.

VII.

That the Regulations of the Administrator enacted pursuant to the aforesaid Section 2(g) of said Act, requires that a note be valid and enforceable in order to qualify for insurance.

VIII.

That since the Citizens National Trust and Savings Bank of Los Angeles, supplied the named dealer-payee with the bank's own printed forms of Promissory Note and Federal Housing Administration Title I Credit Application for use in the transaction involved, the Bank was charged with knowledge that the transaction was subject to the Regulations promulgated by the Federal Housing Administrator." [R. 18-20.]

B.

The Trial Court Did Not Err in Ruling That "A Judge of This Court Heretofore Having Held That the Note Was Not Valid and Enforceable Against the Borrower, This Court Cannot Go Behind Such a Finding."

As shown above, Judge Westover, the trial judge herein, by virtue of said Stipulation between the parties, had before him the same facts relative to the execution of the "promissory note" as had Judge Mathes in *United States v. Bashore*. Under these facts, Judge Westover's conclusion that the note was not valid and enforceable against the borrower, as required by the Appellee's regulations, is clearly correct, even if it be conceded, *arguendo,* that the reason he gave for this conclusion is unsound.

Under said Stipulation, and also as implied from the trial issues framed by the parties, the trial judge herein was required to assume that the maker of the note, George D. Bashore, was approached by agents of the Durastone Company; that said agents misrepresented basic facts to said defendant; that as a result said defendant was made to believe that certain mastic paint would be applied to defendant's home free of charge; that said defendant did execute and sign a "promissory note" and other documents in question, the true effect of which was misrepresented to him; that defendant George D. Bashore did not know or ascertain until long after the event that he had signed the instrument in suit or any other document negotiable in form; that the consideration promised by the Durastone Company had not been received by the defendant and is totally lacking, and that the defendant, George D. Bashore, by his conduct and lack of knowledge may not under the evidence presented be held negligent [R. 19-21].

On such facts, it is well settled that the purported maker of the "Promissory Note" could not have executed a binding obligation, negotiable or otherwise. It has been found that Bashore did not know, because of the payee's fraud, that he was signing a "note." And where there is fraud in the *factum* there can be no note eligible for Title I insurance under any reasonable theory, whether or not the instrument is regarded as "complete and regular on its face." It cannot be denied that in assigning the instrument Appellant warranted that it was a "note" which qualified for insurance. If the instrument possessed none of the legal consequences of a note, the warranty was breached on that ground alone.

In *C. I. T. Corp. v. Panac* (1944), 154 P. 2d 710, 25 Cal. 2d 547, it was held that "absent negligence on the part of the maker, where the note was signed under a mistaken belief that it was a different instrument as a result of fraud on the part of the payee, it is not enforceable by a holder in due course." The Supreme Court of California pointed out that the common-law distinction between "fraud in the inducement" and "fraud in the factum" has been recognized in California since the adoption of the Uniform Negotiable Instruments Law.

25 Cal. 2d 550, 552.

As to the destruction of negotiability by fraud in the *factum* see *Brannon, Negotiable Instruments Law,* No. 55 (Beutel, 6th Ed. 1938); *Ames,* "Specialty Contracts and Equitable Defenses," 9 Harv. L. Rev. 49, 51-52; and *Williston on Contracts* (Rev. Ed.), Sec. 95A. These compendia indicate that the Uniform Negotiable Instruments Law, or similar statutory enactments, have not abrogated the common-law principle that fraud in the *factum* nullifies the "note."

Therefore, assuming that the law of California determines whether a promissory note, negotiable or otherwise was ever executed in this case, it is evident that the answer to such question must be in the negative. It is also evident that the same result would be reached under general principles of the common law, or under any statute or code which did not expressly or by necessary implication repeal the common-law rule. The provisions of the California Civil Code relative to negotiable instruments contain no such language, and none has been cited by the Appellant.

This well-settled principle renders meaningless the Appellant's argument that the requirement that the note be "valid and enforceable against the borrower" should be equated with the contiguous requirement that it be "complete and regular on its face" even though the two criteria are stated in the conjunctive. (The almost transparent fallacy of this contention is discussed below.) Clearly, insurability under the National Housing Act presupposes the execution of some form of instrument which could bind the maker in the hands of a holder in due course.

Since no binding instrument of any kind had been executed by the borrower herein, the Appellant did not assign to the Appellee any note which was "valid and enforceable against the borrower," however the quoted words be defined. It follows, in turn, that said "note" could not qualify for insurance under the requirements of 24 C. F. R. 201.3(a), *supra,* and that, therefore, the bank breached its warranty upon assigning it to the United States, as found by the trial court below.

In this connection, a very recent decision by the Fourth Circuit Court of Appeals in *United States v. Bland* (4 Cir., Nov. 13, 1958), ... F. 2d ......, is of considerable

relevancy. Bland had purchased storm windows from a contractor who, without recourse, assigned an F.H.A. insured note to the loan association. After default, the Commissioner paid the balance due and received an assignment. Thereupon, the United States sued the maker of the note, as in the related case of *United States v. Bashore* herein. The trial court held that the contractor had not complied with the Maryland Retail Installment Sales Act and that, therefore, the note was voidable. Consequently, judgment was given for the defendant, as in *United States v. Bashore.* However, the court observed that since the loan association had given a warranty to the United States that the note qualified for insurance, the United States might have a right to recover its loss from the loan association, although not from Bland. On appeal, the judgment was affirmed on the opinion below.

The dictum in *Bland* clearly conflicts with Appellant's argument that the test of insurability under the Federal Housing Act and its regulations is that the note be "complete and regular on its face." It appears that the note in *Bland* so qualified. Indeed, the *Bland* dictum goes farther than did the trial court herein, since it also appeared that the loan association there was not chargeable with knowledge that the said Installment Sales Act had been violated, whereas Judge Mathes in *United States v. Bashore* found that the appellant herein was chargeable with knowledge because of its close relationship to the defrauding payee. Presumably, the Fourth Circuit Court of Appeals held that since the Bland note was voidable *ab initio,* the loan association could not become a holder in due course under any circumstances since it had not acquired a valid instrument, which is essentially the situation present here.

Quite apart from the fact that the trial judge, having before him by stipulation the same basic facts as found by the court in *United States v. Bashore,* could not properly have reached any other conclusion but that the note in question was invalid and unenforceable, it is submitted that he would have been warranted in accepting the findings and conclusion of a brother judge of the same court in such a closely related case, involving the same note and the same transaction. As discussed more fully below, the parties to this appeal were in privity, bearing the relationship not only of assignor and assignee but of insured and insurer as well as of warrantor and warrantee. Moreover, the Appellant has impliedly conceded that he was informed of the action of *United States v. Bashore* before trial and that its counsel attended the trial. Under such circumstances, the rule, well-established in the Ninth Circuit, that one judge should not overrule the decision of a brother judge of the same court in the same case, or even in a different case involving the same rules of practice, procedure, property, or status, should apply. Reference is made to the trial judge's Memorandum of Opinion [R. 26-29] and to the citations given therein, some of which are discussed in greater detail below.

In *United States v. United States Smelting Company,* 339 U. S. 186 (1950), the Supreme Court of the United States said:

> "The rule of the law of the case is a rule of practice, based upon sound policy that when an issue is once litigated and decided, that should be the end of the matter."
>
> 339 U. S. 198.

As early as 1871 Justice Field, sitting as Circuit Justice in the case of *Cole Silver Mining Company v. Virginia and Gold Hill Water Company* (C. C. D. Nev. 1871), 6 Fed. Cas. 72, refused to entertain a motion to dissolve an injunction previously issued in the same case by another judge, reasoning that

> "I could not with propriety reconsider his decision, even if I differed from him in opinion. The circuit judge possesses . . . equal authority with myself in the circuit, and it would lead to unseemly conflicts, if the rulings of one judge, upon a question of law, should be disregarded or be open to review by the other judge in the same case."
>
> 6 Fed. Cas. 74.

Although the above decision concerns a prior action within the same case, the situation here is analogous since by stipulation the parties accepted the same basic facts found in *United States v. Bashore.* Therefore, as to the common issue of the enforceability of the note, the two cases are identical.

Moreover, the rule of comity between judges of the same court has been extended so as to embrace different cases which present the same factual and legal problems. This is clearly shown by the dictum in *Shreve v. Cheesman* (8 Cir., 1895), 69 Fed. Rep. 785, cert. den. 163 U. S. 704. Although the facts in that case were peculiar and brought into focus a question of reliance and equitable estoppel not present here, the language of the court showed that it strongly approved the rule that judges of the same court should not overrule each other's decisions on similar questions, even in different cases. The court said:

> "Nor has it been thought less vital to a wise administration of justice in the federal courts that the

> various judges who sit in the same court should not attempt to overrule the decisions of each other, especially upon questions involving rules or property or of practice, except for the most cogent reasons."

The court then cited with approval *Cole Silver Mining Company v. Virginia and Gold Hill Water Company, supra,* as well as other earlier cases.

69 Fed. Rep. 791.

For a similar dictum in a more modern case, which shows that the foregoing rule of comity is well entrenched in the Third Circuit, see *C. T. F. Film Corp. v. Gowley* (3 Cir., 1957), 240 F. 2d 711, 713; for a contrary view see *Dictograph Products Co. v. Sonotone Corp.* (2 Cir., 1956), 230 F. 2d 131, 134-135.

If it be contended that the foregoing decisions are restricted to the same questions of law, it may be answered that the enforceability of the note against the borrower herein presents merely an issue of law, identical with that in *United States v. Bashore,* since the parties agreed to accept the basic findings in the latter case and offered no evidence as to anything else. Consequently, a contrary ruling by the trial judge in the instant case would have reversed the conclusion of a judge of the same court in a closely related case involving the same facts.

While *Carnegie National Bank v. City of Wolf Point* (9 Cir., 1940), 110 F. 2d 569, involved a conflict between judges of the same court *in the same case,* and thus is distinguishable to that extent, it is significant that this

court quoted with approval the statement of the Eighth Circuit in *Shreve v. Cheesman, supra,* that

> "the various judges who sit in the same court should not attempt to overrule the decisions of each other, especially upon questions involving rules of property or of practice, except for the most cogent reasons."
>
> 110 F. 2d 573.

In the very recent case of *Rojas-Gutierrez v. Hoy* (U. S. D. C. S. D. Cal. C. D. 1958), 161 Fed. Supp. 448, the trial judge ruled that the conclusion of a judge of the same court that marihuana is not a "narcotic drug" within the meaning of an amendment to the Immigration and Nationality Act should be approved by him "without further study" where it was not shown that such a conclusion was "patently erroneous."

161 Fed. Supp. 451.

Said case is analogous to the one at bar since the identical question arose in a different case. Indeed, the ruling therein goes considerably further because in the instant situation some of the parties to both cases are in privity or other legal relationship and the basic facts are identical.

Moreover, it may logically be argued that by the aforesaid Stipulation the Appellant, in effect, accepted the conclusion of the District Court in *United States v. Bashore* that the "note" was invalid and unenforceable against the borrower and elected to rest his case upon the argument that, even so, it was within the insurance coverage provided by the National Housing Act since it was "complete and regular on its face" and since Appellant had no actual knowledge of any infirmity in the instrument. Having made such election, it is much too late now to rescind it.

C.

The Trial Court Did Not Err, as Appellant Contends "in Concluding in Effect That in Every Case Where a Promissory Note Is Made and Given Under the Terms of Title I of the National Housing Act, and Is Later Found to Be Invalid and Unenforceable Against the Borrower, That This Is Necessarily Conclusive That the Note Would Be Ineligible for the Insurance Coverage Under Said Act" Since It Reached No Such Conclusion and Since Such a Conclusion Would Be Superfluous in Any Event (emphasis supplied).

Assuming, *arguendo,* the correctness of Appellant's contention that under the National Housing Act and the regulations relative thereto a note, under certain circumstances, might be invalid and unenforceable against the borrower and still qualify for insurance—an assumption which is deemed wholly unsound—the fact remains that the trial court merely concluded that the "note" was not valid and enforceable against this particular borrower because its execution had been permeated by fraud to such an extent that he did not know he was signing a note. As shown above, this conclusion accords with the almost universally approved rule that fraud in the *factum* renders a purported note void, not only as against the payee but as against any successor in interest, regardless of the latter's good faith. This, it follows that in the instant case no note in a legal sense was ever executed, so that the insurance provisions of the Act and its regulations, which undeniably require the execution of a written acknowledgment of indebtedness enforceable by a holder in due course, at least, were fatally violated.

The sole question presented here is whether the trial judge's conclusion that *this particular note was not qualified for insurance* is correct. If it is correct, then whether he reasoned from an unsound premise, or stated a correct one too broadly, is immaterial. Although the Appellee believes that any note not valid and enforceable against the borrower in the lender's hands is ineligible for insurance under the plain meaning of 24 C. F. R. 201.3(a) of the regulations, such a comprehensive question need not be decided here. It is difficult to understand how the Appellant can seriously argue that a note, admittedly impregnated with fraud to such an extent that the maker did not know the meaning or purpose of the instrument before him, can possibly qualify for insurance under the Act, whether or not the conduct of the Appellant was faultless. As explained in greater detail below, such a result would be wholly inconsistent with the general context and purpose of the Act and the specific requirements of its governing regulations.

Therefore, whether the trial court in *United States v. Bashore* was technically correct in ruling that the Appellant was not a holder in due course because it was chargeable with knowledge of the fraud, which ruling was adopted by the trial court herein, is immaterial. If said ruling be error, it is error which does not vitiate the ultimate conclusion that the instrument here in question did not qualify for insurance.

D.

The Trial Court Did Not Err, as Appellant Contends, by "Casting the Role of the Appellee as Being That of an Assignee of an Ordinary Promissory Note, Rather Than That of an Insurer to a Lending Institution Against Loss Occasioned by a Loan Made Under the Terms of the National Housing Act," Because the Trial Court Applied No Such Theory and Because in Any Event, It Is Not the Theory Applied but the Conclusion Reached Which Is Determinative.

If any answer to such a flimsy specification is necessary, reference to Finding VIII by the trial judge [R. 32-33], in conjunction with his Conclusion of Law III [R. 34], is a sufficient refutation. The Appellant concedes that it assigned the "note" to the Appellee without recourse but subject to a warranty that it "qualified for insurance." The trial judge ruled, in effect, that a note which was invalid and unenforceable against the borrower in the hands of the assignor (Appellant) could not qualify for insurance in view of the express requirement of the controlling regulation (24 C. F. R. 201.3(a)), as quoted above. To argue now, in the teeth of the findings and conclusions reached by the trial judge, that he treated the transaction as an ordinary assignment is very close to frivolity. But even if he had failed to consider or understand the insurance aspects of the transaction, his ultimate conclusion that the "note" did not qualify for insurance is clearly correct on the record and so would require the affirmance of this court.

E.

The Trial Court Could Properly Refuse to Litigate the Issues Actually Decided in United States v. Bashore Because of Privity or a Similar Relationship Between Appellant and Appellee.

It is conceded that the appellant was not made a party to the action in *United States v. Bashore,* No. 19527-WM Civil, and is not a party to the judgment therein, as found by the trial court [R. 32]. Appellee agrees that Appellant is not bound by the judgment in said action under the doctrine of *res judicata,* that is, is not precluded from litigating issues which might have been raised and decided in said previous action but were not.

However, without regard to the Stipulation of Facts executed by the parties to this appeal and without regard to the doctrine of comity between judges of the same court, both of which have been discussed above, it is submitted that with respect to *United States v. Bashore* the Appellant was in privity with the Appellee and is, therefore, precluded from litigating herein the same issues actually heard and decided in that action.

The findings of fact in *United States v. Bashore* were essentially as follows:

1. That the purported "promissory note" was void because of fraud in the factum, especially since the maker "did not know or ascertain until long after the event that he had signed the instrument in suit or any other document negotiable in form" [R. 19];

2. That since the Appellant supplied the payee with its "own printed forms . . . for use in the transaction involved," it was charged with knowledge that the transaction was subject to the regulations of the Federal Hous-

ing Administrator and therefore took the purported promissory note "with knowledge of the defects therein and did not therefore become a holder in due course" [R. 20];

3. That the relationship between the payee and the Appellant as to the entire transaction was such that the Appellant must be considered in effect a party to the original transaction between the named payee and the maker of the "note" [R. 20].

The conclusions of law in said case were essentially as follows:

1. That the maker of the "note" (George D. Bashore) was not guilty of negligence in executing it or the related documents [R. 21];
2. That the Appellant did not become a holder in due course of said "note" [R. 21] but discounted it "with knowledge that said note was void and unenforceable" [R. 22].

It is submitted that the Appellant is estopped from challenging any of the foregoing findings of fact or conclusions of law as rendered in *United States v. Bashore,* at least since it had knowledge of said action previous to trial, as found by the trial court herein [R. 33] and did not deny that its counsel was in attendance during the trial. Although said Stipulation of Facts did not cover the latter question, the Appellee averred in its trial Memorandum of Points and Authorities that the Appellant not only knew of said action but that its counsel was present at the trial. Neither contention has ever been denied by the Appellant and presumably for this reason the trial court found that Appellant was informed of said action prior to trial [R. 33]. Although this falls short of finding that Appellant's counsel actually attended the

trial, as further contended by the Appellee and as still undenied by Appellant, it is sufficient to bring this case within the scope of those more restrictive decisions relative to collateral estoppel which require knowledge of the previous action and an opportunity to participate therein.

Exclusive of agency situations—such as where the assignee has been made such in order to bring an action for the assignor—it would be difficult to find a case which provides a more reasonable basis for applying the doctrine of collateral estoppel than the case at bar. Here the parties, by virtue of the same instrument, were related not only as assignor and assignee but as insured and insurer and warrantor and warrantee. This multiple relationship created such a bundle of intertwining rights and obligations that the parties concerned must be deemed in privity with respect to any legal action for the enforcement of said instrument. The Supreme Court of the United States has held that a "right, question or fact, distinctly put in issue and directly determined by a court of competent jurisdiction as a ground of recovery, cannot be disputed in a subsequent suit between the same parties *or their privies, even if the second suit is for a different cause of action.* so long as the judgment in the first suit remains unmodified." (Emphasis supplied.)

> *So. Pac. RR. Co. v. United States* (1897), 168 U. S. 1, 48-49, 18 S. Ct. 18; quoted with approval in *Driggers v. Business Men's Assurance Co. of Canada* (5 Cir., 1955), 219 F. 2d 292.

Similarly, the Supreme Court of the United States has said:

> "Estoppel resulting from the thing adjudged does not depend upon whether there is the same demand in both cases but exists, even although there be different

demands, when the question upon which recovery of the second demand depends has under identical circumstances and conditions been previously concluded by a judgment between the parties or their privies."

New Orleans v. Citizens' Bank (1897), 167 U. S. 371, 396.

It is clear that in the instant case, the circumstances and conditions surrounding the execution, endorsement, and assignment of the purported promissory note were identical to those present in *United States v. Bashore.* Indeed, both parties recognized such identity by stipulating to the basic facts found in the previous action. The question whether the "note" at issue qualified for insurance under the regulations depends upon the facts surrounding its execution and subsequent transfers. Therefore, those facts which were the foundation for the judgment in *United States v. Bashore* are necessarily basic to the instant suit also.

Where the parties are in such a close legal relationship and where the same transaction is involved, all of the conditions necessary for the proper application of the principles of privity and collateral estoppel are present, even under a strict interpretation.

Cases involving the doctrine of *res judicata,* as cited by the Appellant, are not germane. Since the instant case differs from *United States v. Bashore* not only with respect to the cause of action but with respect to the parties in suit, Appellee does not contend that the Appellant is bound by the doctrine of *res judicata*, that is, is barred by the judgment in said suit, and has at no time sought to invoke that doctrine. Appellee concedes that where a former judgment is relied upon as an absolute bar, there must be, as between the two actions, an iden-

tity of parties, of subject matter, and of cause of action. There is, however, a clearly-defined distinction between that type of case and one wherein some controlling fact has been adjudicated in a prior proceeding by a court of competent jurisdiction and that same fact is now at issue between the same parties or their privies. In the latter case, the adjudication of said fact in the first suit will be conclusive, irrespective of whether the cause of action is the same.

> *Leopold v. City of Chicago* (1894), 150 Ill. 568, 37 N. E. 892, 893-894.

It is of decisive significance that the defense in *United States v. Bashore* was primarily based upon the fact that the "note" was obtained by fraud and that the defendant therein did not know he had executed an instrument which purported to be a note. It has been held by the Supreme Court of Illinois that if an instrument has been forged, or is usurious, or subject to other defects rendering it worthless, and if the endorser has been notified of such defense in an action to enforce the obligation, he will be bound by a judgment against the party whom he is obliged to indemnify.

> *Drennan v. Bunn* (1888), 124 Ill. 175, 16 N. E. 100.

See also:

> *Oulvey v. Converse* (1927), 326 Ill. 226, 157 N. E. 245, 247.

The same court has held that the endorser of a forged or usurious note is a person having a direct interest in an action on that note.

> *Butz v. Schwartz* (1890), 135 Ill. 180, 25 N. E. 1007.

The situation here is certainly analogous.

It has also been held that where an endorsee or holder of a note is defeated in an action against the maker and then sues his endorser or assignor, the latter is bound if he had notice of the prior suit and an opportunity to participate in it.

Bullock v. Winter (1851), 10 Ga. 214.

See also:

Oulvey v. Converse (1927), 326 Ill. 226, 157 N. E. 245; 34 C. J. p. 1025, note 84 and cases cited.

Similarly, it has been decided that a judgment on the merits in favor of the maker of a note, in an action against him by the holder, whether as payee or endorsee, is conclusive in favor of the maker in a subsequent suit against him by another plaintiff, whether as payee or endorsee.

Illinois Conference v. Plagge (1898), 177 Ill. 431, 53 N. E. 76.

Another case in point is that of *Norfolk Packing Co. v. American Insurance Co. of Newark* (1930), 120 Neb. 19, 231 N. W. 148, wherein it was held that a final judgment holding another insurance policy did not cover the property damaged was "res judicata" of the right of the defendant-insurer to prorate the loss under a tornado policy on the ground that additional insurance existed. It should be noted that the prior action pertained to a different company, that said defendant-insurer had not been a party thereto, and that the only element of privity, apparently, was that both companies had insured the same property and the same factual issue was involved.

Moreover, modern cases have shown an increasing tendency to expand the doctrine of collateral estoppel and to depart from narrow concepts of "privity" when necessary

to prevent the relitigation of identical issues. In *Vasu v. Kohlers* (1945), 145 Ohio St. 321, 61 N. E. 2d 707. the Supreme Court of Ohio held that an automobile owner, who had assigned to his insurer the claim for property damage arising out of a collision, was bound by the judgment rendered against the insurer, in its action against a negligent third party, to the extent of the assigned claim. Although it appears that the result reached may have been influenced to some extent by provisions of the General Code of Ohio (Secs. 11241 and 11306) the language of the court indicates that it considered its decision in accord with common-law principles. It conceded that a grantor or assignor was not bound, as to third parties, by any judgment which a third person obtained against the assignee with respect to the interest transferred unless made a party to the action or unless related otherwise to such an extent as to be in privity. Recognizing this as a general rule, the court nevertheless said that if the owner of a single cause of action arising out of a single tortious act assigns a part thereof to another, a recovery or failure to recover by such other, as assignee, on the assigned claim should extinguish the cause of action and bar any further prosecution of it by the assignor against the tort-feasor,

> 61 N. E. 2d 711, citing *Sprague v. Adams* (1926), 139 Wash. 510, 247 Pac. 960.

This follows, continued the court, not because of any privity between the assignor and assignee, but because there cannot be a splitting of a single, indivisible cause of action. It concluded that the success or failure of *either the assignor or assignee* in the prosecution of their respective claims against the tort-feasor extinguishes the entire cause of action.

> 61 N. E. 2d 711.

It is submitted that the foregoing analysis makes good sense and that good sense usually makes good law. It is also submitted that the rationale of *Vasu v. Kohlers,* would bar the relitigation of the enforceability of the note in the instant case.

Another case which departs from the traditional confines of privity in order to achieve the desirable result of preventing the duplicative litgiation of identical issues is *Jenkins v. Atlantic Coast Line Ry. Co.* (1911), 89 S. Car. 408, 71 S. E. 1010. There it was decided that since the owner of a railroad is liable for injuries caused by those allowed to use it, a railroad which leased to another was in such a close legal relationship to the lessee that where a third party sued the lessor for injuries and lost, the judgment operated to bar a subsequent suit against the lessee.

71 S. E. 1012.

The court stated that the basis for its decision could not be rested upon the doctrine of *res judicata* or collateral estoppel because the parties to the suits were not the same and because they were not technically in privity. However, it said that in cases of this kind the principle of estoppel should be expanded on the ground of public policy, so as to embrace persons not strictly parties or privities. It is a wholesome principle, argued the court, that any litigant should have one fair opportunity to try his case upon the merits, but only one such opportunity.

71 S. E. 1012.

Accord:

Eagle Star and British Dominions Insurance Co. v. Heller (1927), 149 Va. 82, 140 S. E. 314.

See also:

State Farm Mutual Auto Insurance Co. v. Wright (1939), 173 Va. 261, 3 S. E. 2d 187.

Concededly, the *Jenkins* case is distinguishable in that there the party *against* whom the doctrine of estoppel was invoked had appeared in both actions, whereas here the party who appeared in both actions, that is, the Appellee, is seeking to invoke the doctrine against a third party, the Appellant. However, the reasons which underlie the *Jenkins* rule apply just as strongly to the instant case since Appellant had been fully informed of the prior action, had a fair opportunity to participate therein, and had, in fact, been present at the trial. Moreover, in both the *Norfolk Packing Co.* case and that of *Vasu v. Kohlers, supra,* the party estopped had not appeared in the previous action.

Furthermore, the parties herein voluntarily stipulated to the same basic facts found in *United States v. Bashore.* Therefore, the trial judge held, in effect, that under identical facts he was obligated to follow the previous conclusion of a judge of the same court that the "note" was not valid and enforceable against the borrower. We submit that this principle of comity between fellow judges is sound and should be approved, as to which see our discussion and citations above. But we also submit that, regardless of comity, the same result would be required by the proper application of collateral estoppel.

The decision of the Seventh Circuit Court of Appeals in *Le Duc v. Normal Park Presbyterian Church* (7 Cir., 1944), 142 F. 2d 105, cert. den. 323 U. S. 729, is of some relevancy. There it was held that a judgment for the defendant by a state court in an action between the plaintiff's assignee and the defendant created an estoppel by verdict as between the plaintiff and the defendant. The court stated that privity existed between the plaintiff and his assignee and that such privity created an effective estoppel. Although this result was reached under Illi-

nois law, which is liberal in its doctrine of privity, it may be inferred from the language of the decision that the Circuit Court also approved in principle.

The proper approach to the question presented here was well stated by the Supreme Court of Delaware in *Coca-Cola Co. v. Pepsi-Cola Co.* (1934), 6 W. H. Del. 124, 172 Atl. 260, as follows:

> "The question of who is concluded by a judgment has been obscured by use of the words 'privity' and 'privities,' which are scarcely determinative always of who is or who is not bound by a judgment. Courts have striven sometimes to give effect to the general doctrine that a judgment is only binding between parties and privities by extending the signification of the word 'privities' to include relationships not originally embraced in it, whereas the true reason for holding an issue is res judicata does not necessarily depend on privity but on the policy of the law to end litigation by preventing a party who has had one fair trial of a question of fact from again drawing it into controversy."
>
> 172 Atl. 263.

Accord:

Taylor v. Sartorius (1908), 130 M. A. 23, 108 S. W. 1089, 1094;

Hoskins v. Hotel Randolph Co. (1926), 203 Iowa 1152, 211 N. W. 423, cert. den., *Otis Elevator Co. v. Hoskins,* 275 U. S. 566;

Hochster v. City Bank Farmers Trust Co. (1942), 24 N. Y. S. 2d 110, 260 App. Div. 712, aff. 288 N. Y. 588, 42 N. E. 2d 600.

With respect to California cases which have similarly expanded the doctrine of privity, and which may be regarded as precedents for its application here, see *Bernhard v. Bank of America* (1942), 19 Cal. 2d 807, 122 P. 2d 892, and *Perkins v. Benguet Consolidated Mining Co.* (1942), 55 Cal. App. 2d 720, 132 P. 2d 70, hearing denied, California Supreme Court, 1943. Said cases are well digested in 57 Harv. L. Rev. 98-99, under the comment that "the fact that a judgment frequently has a conclusive effect upon those who are neither parties to the action nor privies, as that word is commonly used, is illustrated by two recent California cases."

We doubt that the Appellant would seriously argue that it would not be estopped in a suit against Bashore. If, then, Appellant would be so bound by the issues decided in said prior action although not a party thereto, why should it not be bound by the same issues herein? It is evident that to hold that the Appellant is estopped by the findings in *United States v. Bashore* from relitigating the enforceability of the note would not go nearly so far as several of the decisions cited above.

It is submitted that the multiple relationship between the parties to this action (insured to insurer, endorser to endorsee, warrantor to warrantee) created a close bond of privity, no matter how strictly that term is defined. It follows, then, that the only issue which Appellant is entitled to litigate in this action is the insurability of a "note" which was void and unenforceable against its maker.

F.

The Trial Court Was Clearly Correct in Deciding That the "Note" in Question, Having Been Found Invalid and Unenforceable Against the Borrower, Did Not Qualify for Insurance and, Therefore, That the Appellant Breached Its Warranty to the Appellee.

This argument presupposes that the note must be found unenforceable against the borrower, for reasons given above.

The National Housing Act, 12 U. S. C. 1701, *et seq.*, authorizies the Commissioner to insure

> "banks . . . and other such financial institutions . . . against losses . . . as a result of loans and advances of credit, and purchases of *obligations* representing loans and advances of credit, . . . for the purpose of financing additions, repairs, and improvements upon or in connection with existing structures . . . by the owner thereof . . ." (Emphasis supplied; 28 U. S. C. 1703(a)).

The Act further provides:

> "(b) No insurance shall be granted under this section to any such financial institution with respect to any *obligation* representing any such loan . . . (1) if the amount of such loan . . . exceeds $2,000 . . . (2) if such *obligation* has a maturity in excess of three years and 32 days . . . or (3) unless the *obligation* bears such interest, has such maturity, . . . as the Commissioner shall prescribe . . ." (Emphasis supplied; 28 U. S. C. 1703(d)).

Finally, under Section 1703(g) of said Act, the Commissioner "is authorized and directed to make such rules and regulations as may be necessary to carry out the provisions of this subchapter."

The foregoing provisions show that the type of transaction contemplated is one whereunder the financial institution extends credit to the contractor-payee and takes an endorsement of the owner-payor's promissory note or other evidence of indebtedness. It is equally as clear that the Act itself contemplates the creation of an instrument which is valid and enforceable against its maker, at least in the hands of a lender who takes it in good faith, since it contains such phraseology as "purchases of obligations," and "unless the obligation." Of course, an instrument which is invalid *ab initio* because of fraud cannot create any obligation against its maker, no matter how innocent the endorsee may be.

Therefore, apart from any implementing regulations by the Commissioner, the National Housing Act itself requires that the note here in question must have been an obligation of the borrower when received by the Appellant in order to qualify for insurance. Any regulation to the contrary would be invalid.

The regulations, moreover, fully support and implement the foregoing requirement. The decisive provision is found in 24 C. F. R. 201.3(a), entitled "Eligible Notes—Validity" which, *inter alia,* provides: "The note shall bear the genuine signature of the borrower as maker, shall be valid and enforceable against the borrower or borrowers as defined in Section 201.2(i), and shall be complete and regular on its face." Section 201.2(i), which defines the term "borrower" is of little importance but is discussed below in reply to a contention by the Appellant.

The nub of Appellant's argument is that since the "note" in question was "complete and regular on its face" (which is conceded) and since Appellant purchased it in good faith (which is contrary to the finding in *United*

States v. Bashore, a finding impliedly adopted by the trial court here), it falls within the insurance coverage provided by the law. In effect, the Appellant contends that the Act and the regulations thereunder are in derogation of the ancient common-law principle that a contractual instrument so saturated with fraud that the maker did not know its meaning or purpose is a legal nullity. Such an instrument, if it purports to be a promissory note, creates no "obligation" against its maker in favor of anyone, as explained above, and thus cannot transmit any rights to any endorsee, no matter how innocent.

The interpretation sought by Appellant finds no support in the Act or regulations. On the contrary, it distorts the plain meaning of the language used and violates several canons of statutory construction.

What Appellant seeks to do is to equate the requirement that the note "be valid and enforceable against the borrower" with the requirement that it must be "complete and regular on its face," despite the fact that they are contiguous and are coupled by the conjunction "and" rather than the disjunctive "or."

Appellant's argument, lacking support in the context of the Act, in its legislative history and purpose, and in the administrative regulations thereunder, would be weak even if the disjunctive had been used; but faced with "and" instead of "or" it is completely untenable. Therefore, since a purported note which is void for fraud is not enforceable against the payor by anyone, no matter how aptly drafted and no matter what technically correct attachments are executed by payor or payee, the instrument in suit did not qualify for insurance.

There is nothing in other regulations which fortifies the Appellant's argument in any way. On the contrary, they strengthen the position of the Appellee.

For example, 24 C. F. R. 201.11 entitled "Claims-(a) Claim Application" states:

> "Claim for reimbursement for *loss on an eligible loan* shall be made on a form provided by the Commissioner, and executed by a duly qualified officer of the insured. *The claim shall be accompanied by the insured's complete credit and collection file pertaining to the transaction."* (Emphasis supplied.)

Presumably, the requirement that the credit and collection file of the insured be "complete" is designed, in part, to test the conduct of the payee and the insured during the transaction.

Finally, 24 C. F. R. 202.11(g) entitled "Form of Assignment" provides that the instrument of assignment shall be in the following form:

> "All right, title and interest of the undersigned is hereby assigned (without warranty, *except that the note qualifies for insurance*) to United States of America.
>
> ....
>
> (Financial Institution)"
>
> (Emphasis supplied.)

It is submitted that the foregoing provisions of the Act and the regulations thereunder compel a conclusion that to qualify for insurance a purported note must create an obligation against its maker which is enforceable by the insured.

Other arguments advanced by Appellant is an attempt to support its distorted interpretation of the Act and its regulations are equally fallacious.

For example, on page 13 of its brief, it states:

> "It will be found that the intent of the whole system and regulatory measures is to protect the lending

> institution and afford it the insurance when such lending institution acts in good faith in reliance upon the Act and otherwise complies with the regulatory measures prescribed therein."

Of course, since the question in issue is whether Appellant had complied "with the regulatory measures prescribed therein;" this sort of argument—which abounds in Appellant's brief—begs the basic issue. Moreover, if the Appellant means to contend that the primary purpose of the regulations is to "protect the lending institution," it is clearly incorrect since even a cursory reading reveals that the main objective is to assist and protect the borrower and that the inducements offered the lending institutions are in furtherance of this purpose. The Appellant has conveniently overlooked the primacy of the borrower in the "Title I" program and the desire of Congress to avoid any regulatory system which would encourage the commission of frauds by unscrupulous contractors or laxity in investigation and supervision by the banks.

Indeed, the Appellant refutes its own argument on this point by a subsequent quotation which appears on page 9 of its brief. The pertinent part of this quotation (which is taken from page one of a guide to the regulations issued by the Commissioner, entitled "Title One, National Housing Act, Its Regulations, Its Declared Administrative Policy—Summary of Pertinent Provisions" but more commonly known as "FHA-20") is as follows:

> "The operation of the Title One program is based on the *good faith of all concerned*—the good faith on the part of the individual borrower who applies for and receives a loan, the *good faith of the dealer or contractor* carrying out the terms of this contract and rendering proper service to the customer, *the good faith of financial institutions*. . . ." (Emphasis supplied.)

Clearly, then, the good faith of the contractor and the good faith of the lending institution are important. It is certainly in harmony with the Title I insurance system to rule that where the contractor's fraud surrounded the execution of the "note" to such an extent that the borrower did not realize he was signing a note, such a transaction is wholly outside the coverage of the Act and that any bank which participates in it, even in good faith, must bear the risk involved.

On page 9 of its brief, the Appellant quotes from page 3 of said guide to the regulations "FHA-20," as follows:

> "If default occurs and claim for reimbursement for loss is made by the lending institution, the claim will be paid upon proper audit and findings that the *loan was handled in accordance with the regulations.*" (Emphasis provided by Appellant.)

Here again we have an obvious instance of begging the question. The Appellee, of course, contends that this loan was *not* handled in accordance with the regulations and thus did not qualify for insurance. Consequently, such quotations as the foregoing are meaningless.

Page 10 of Appellant's brief bears the following quotation from page 4 of said "FHA-20:"

> *"Where reasonable credit judgment is exercised* and the institution makes a fair volume of loans, the insurance coverage afforded is virtually 100 percent guarantee against loss." (Emphasis supplied.)

Apparently, Appellant believes this quotation indicates that the regulations are designed to afford the banks almost absolute protection. However, the quotation carries its own refutation of that argument, since the clause "where reasonable credit judgment is exercised" obviously applies to the factor of collectibility, so that this language merely

means that where the procedure prescribed by the regulations was followed and the bank exercised "reasonable credit judgment," defaults will be rare and any losses therefrom will be covered by the statutory insurance.

Again, on page 11 of its brief, Appellant quotes the following from 24 C. F. R. 201.6(b):

> "If, after the loan is made, an insured who acted in good faith discovers any *material misstatement or misuse of the proceeds* of the loan by the borrower, the dealer, or others, the *eligibility of the note for insurance shall not be affected.*" (Emphasis by Appellant.)

This merely gives express recognition to the principles governing a holding in due course, such as where the contractor has committed "fraud in the inducement" by misrepresenting his materiel or services or has subsequently failed to keep his promises. Such fraud or breach of contract would not impair the negotiability of the note in the hands of a holder in due course, under familiar principles of commercial law. But there is nothing in this language which indicates that an instrument which a non-negligent maker did not know was a "note" may be regarded as obligating him to anyone.

Moreover, throughout its brief the Appellant assumes that it must be found to have acted in good faith in taking the note in question. No such finding, however, can be made. As indicated above, the Appellant voluntarily executed a Stipulation of Facts, which incorporated by reference the judgment in *United States v. Bashore, supra.* Said judgment included specific findings of fact to the effect that the Appellant was chargeable with knowledge of the infirmities in the instrument because it had given its forms to the contractor and had taken part in the

transaction to such an extent that it virtually made the latter its agent [R. 20]. Although Appellant disputed those findings in its trial briefs, it submitted no proof to the contrary, despite the fact that Appellee's complaint herein incorporated them specifically [R. 6, 13]. Indeed, except by a rather flimsy inference, it did not deny said findings in its answer [R. 10]. Since, therefore, Appellant failed to offer any evidence that a previous finding by a judge of the same court on the same issue was erroneous, it lacks any standing to protest against the application of judicial comity, as discussed above. Moreover, it is also bound by these findings under principles of collateral estoppel, as discussed above. Finally, if it be assumed, *arguendo,* that the affirmative defense of holding in due course is open to Appellant, it would have the burden of proof thereon and, quite apart from principles of comity or estoppel, it must fail on this issue because it offered no proof at the trial.

Consequently, on the question of whether Appellant was a holder in due course, this appeal reaches the court in this posture, that Appellant, if not bound by the previous finding in *United States v. Bashore* that it did not act in good faith, at least has not proven its good faith herein and so must be regarded as having taken the "note" subject to all valid defenses of the maker against the payee.

On page 14 of its brief Appellant, in order to support its argument that the words "valid and enforceable against the borrower" mean the same as "complete and regular on its face," is driven to the extreme of rewriting the controlling regulation (24 C. F. R. 201.3(a)). No doubt, the language and punctuation used by the Appellant would support its theory. The fatal flaw in this strange argument is that Appellant's literary creation, although proof of a vivid imagination, can in no sense be regarded as a

fair paraphrase of the regulation but is a substantially different provision, bearing no resemblance to the actual one with respect to the decisive phraseology. An attempt to equate the authentic words "shall be valid and enforceable against the borrower . . . , *and* shall be complete and regular on its face" (emphasis supplied) with the words "shall, on its face, appear to be complete and regular, valid and enforceable against the borrower . . ." (Appellant's creation) is so patently indefensible as to require no further comment. We are not concerned with the kind of regulation which the Commissioner *might* have adopted but only with the actual language used and the meaning of that language.

On pages 12 and 13 of its brief the Appellant quotes from 24 C. F. R. 201.1(i) with respect to the definition of "borrower" as follows: "One who applies for and receives a loan in reliance upon the provisions of the Act . . ." and then proceeds to argue that the "reliance" referred to is that of the lender and not the borrower. This has some merit since it seems logical to conclude that the borrower is interested in utilizing the Act merely to obtain a loan under moderate terms and, having obtained it, does not look to the Act for future benefits or protection. It is probable that after the loan is made and its terms defined most borrowers have little interest in the insurance system created by Title I and in the regulations which implement it. However, Appellant's play on words fails to fortify its theory. The "reliance" mentioned is that "upon the provisions of the Act," which, of course, incorporates the regulations thereunder. Therefore, once again the Appellant begs the basic question. Certainly, it was entitled to rely "upon the provisions of the Act" but the sixty-four-dollar question is what those provisions mean with respect to the issues presented by this appeal.

The answer to the foregoing question must be found by analyzing the entire context of the Act and its regulations, with due regard for their objectives as revealed by the language used and by their legislative and administrative history. While unnecessary to the determination of this appeal, it is submitted that the protection afforded the lending institution is essentially against the risk of collection rather than negotiability, that with respect to the latter the lender, if it acts in good faith, receives the same protection as any holder in due course under general commercial law, no more and no less. The primary purpose of those portions of the Federal Housing Act involved herein is to encourage home repairs and improvements by providing loans on terms favorable to the borrowers. Since Congress knew that many lending institutions normally would avoid such loans because of the rather high risk of default and collection involved, it undertook to insure lenders against this risk. But it did not also undertake to rewrite the law of negotiable instruments in their favor.

G.

The Appellee Is Not Prejudiced Because It May Have Voluntarily Indemnified the Appellant Under a Mistake of Law.

Although Appellant did not expressly contend in the trial court that the Appellee may not recover because it indemnified the Appellant after knowing, or being chargeable with knowledge, of the payor's grievances, it impliedly advanced such an argument by stating that the Appellee had been informed of such grievances but had paid the balance due on the "note" nevertheless, and, therefore, had not been misled. The trial judge, in effect, so found [R. 20-21, Finding XI].

If it be conceded, *arguendo,* that having such knowledge the Appellee should not have indemnified the Appellant voluntarily, it is not prejudiced by its error in having done so. This court has recently ruled that a voluntary payment by the United States under a mistake of law may be recovered.

> *Kingman Water Co. v. United States* (9 Cir., 1958), 253 F. 2d 588, 590.

In the *Kingman* decision this court said:

> "The third argument is that money voluntarily paid over under mistake of law is not recoverable. A case or two to that effect is cited. However, the rule apparently does not apply to the Government. See Brooklyn & Richmond Ferry Co. v. United States, 2 Cir., 167 F. 2d 330. The Supreme Court in United States v. Wurts, 303 U. S. 414, 58 S. Ct. 637, 638, 82 L. Ed. 932, states:
>
> > 'The Government by appropriate action can recover funds which its agents have wrongfully, erroneously, or illegally paid * * * The Government's right to recover funds, from a person who received them by mistake and without right, is not barred unless Congress has "clearly manifested its intention" to raise a statutory barrier.' "

Since the Federal Housing Act manifests no intent by Congress to estop the United States from recovering money erroneously paid under the facts here present, the Government's error is immaterial.

VI.
CONCLUSION.

In view of the foregoing principles and precedents, it is respectfully submitted that the judgment of the trial court herein should be affirmed.

Dated: This 24th day of April, 1959.

Respectfully submitted,

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